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No. 86-1109

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

KATHRYN B. CELAURO
as successor in interest to
Martha B. Olsen, Commissioner of Revenue,
State of Tennessee

Petitioner,

vs.

MIDLAND BANK & TRUST COMPANY, *ET AL.*,

Respondents.

**On Petition For A Writ of Certiorari
To The Supreme Court
of Tennessee**

RESPONDENTS' BRIEF IN OPPOSITION

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THE QUESTIONS PRESENTED FOR REVIEW

1. Whether the decision of the Tennessee Supreme Court below was mandated by *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), in which this Court held that Tenn. Code Ann. §67-2704 (the statutory measure of both the tax in *Memphis* and the tax in the instant case) "impermissibly discriminates against the Federal Government and those with whom it deals" and thus violates 31 U.S.C. §3124(a) and the Supremacy Clause of the Constitution of the United States.

2. Whether the decision of the Tennessee Supreme Court below conforms with the prior controlling decisions of this Court.

3. Whether the result reached by the Tennessee Supreme Court is further mandated by the Tennessee Supreme Court's decision of state law issues.

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COUNTERSTATEMENT OF THE CASE

This case involves an attempt on the part of the Tennessee Commissioner of Revenue to relitigate issues which were previously determined in *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983). This case involves a claim for refund for calendar year 1982, the statute having been subsequently amended effective 1983 in order to comply with *Memphis*.

In *Memphis*, this Court determined that Tennessee Code Annotated §67-2704 discriminated in favor of Tennessee obligations and against federal obligations. That statute required the exclusion of Tennessee obligations from the tax base defining "net earnings" but denied the same exclusion to income from federal obligations:

> Under the statute, net earnings include interest received by the bank on obligations of the United States and its instrumentalities, as well as interest on bonds and other obligations of States other than Tennessee, but exclude interest on obligations of Tennessee and its political subdivisions. 459 U.S. at 394.

In *Memphis*, the United States Supreme Court reached the inevitable conclusion that such a tax discriminated against the federal obligations and was therefore invalid.

On remand, the Tennessee Supreme Court enforced the decision of this Court and required an appropriate refund to Memphis Bank & Trust Company under the Tennessee Bank Excise Tax. (Appendix to Petition for Certiorari, A-17 through A-20). The Commissioner, however, resists the attempt of the state courts

to achieve the same result under the Corporate Excise Tax laws. This resistance is ironic in light of the fact that the statute at issue is the same Tenn. Code Ann. §67-2704 which was involved in the bank excise tax decision.[1] It is even more ironic, inasmuch as there is an identity of parties with the earlier case. The current Respondent, Midland Bank & Trust Company, is the former Memphis Bank & Trust Company under a new name. This Petition, in other words, involves one of the same Plaintiffs, the identical Defendant, and the identical statutory provision which were before this Court in *Memphis*.

This Petition also involves matters which, except for the tax year 1982, have been prospectively re-

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[1] The local bank excise tax involved in *Memphis* (Tenn. Code Ann. §67-751) provides that "net earnings shall be calculated . . . as prescribed by chapter 27 of title 67." In that chapter and title, which is the corporate excise tax involved in the instant case, §67-2704 defines net earnings for purposes of both the local bank excise tax and the corporate excise tax. In *Memphis*, this Court noted the operation of Tenn. Code Ann. §67-2704 as follows:

> For purposes of the bank tax, the term "net earnings" is defined as "[f]ederal taxable income" with specified adjustments. Tenn. Code Ann. §67-2704 (Supp. 1982). "Federal taxable income" includes interest on obligations of the United States and its instrumentalities, but does not include interest on state or municipal obligations. See 26 U.S.C. §103(a). Tennessee Code Ann. §67-2704(b)(1)(B) adjusts "federal taxable income" by adding "[i]nterest income earned on bonds and other obligations of other states or their political subdivisions, less allowable amortization." However, no similar adjustment is made to include interest on obligations of the State of Tennessee or its political subdivisions in the definition of "net earnings" subject to the bank tax. 459 U.S. at 394, n. 3.

solved. Following the decision of this Court in *Memphis*, the Tennessee legislature amended the taxing statute to provide that state interest as well as federal interest would be taxed for future years.[2] Meanwhile, in an unreported decision, the Tennessee Supreme Court declined the Petitioner's request that the statute be judicially amended to broaden the tax for those years prior to the legislative enactment. Instead, the Tennessee Supreme Court ruled that equality should be achieved in the previous years by eliminating the illegal tax on federal obligations and requiring a refund. In the case at bar, the Tennessee Supreme Court declined to alter its earlier ruling either by imposing a judicially-created tax on state obligations or by denying retroactive effect with regard to the 1982 calendar year. (Appendix to Petition for Certiorari, A-5 through A-8).

The Petition for Certiorari, therefore, is limited to issues which have previously been ruled on by this Court in the *Memphis* case and which have twice been fully considered and rejected by the Tennessee Supreme Court. It also involves a matter which is of no further prospective concern, inasmuch as the statute in question has been amended by the Tennessee Legislature in light of the earlier opinions.

REASONS FOR DENYING THE WRIT

SUMMARY OF ARGUMENT

The petition for writ of certiorari should be denied because the Tennessee Supreme Court's decision be-

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[2] 1983 Tenn. Pub. Acts, ch. 190, §1; 1983 Tenn. Pub. Acts ch. 227, §2; Tenn. Code Ann. §67-4-805.

low is controlled by *Memphis Bank & Trust v. Garner*, and conforms to all prior decisions of this Court. In fact, this Court has denied certiorari and dismissed appeals in recent cases involving issues raised in the Petition for Certiorari concerning discriminatory state taxes. *Forbes, Inc. v. Department of Finance, City of New York*, 66 N.Y.2d 243, 487 N.E.2d 251 (1985), *cert. denied*, No. 85-1371 (U.S. 1986); *Garfield Trust Company v. Director, Division of Taxation*, 102 N.J. 420, 508 A.2d 1104 (1986), *appeal dismissed*, No. 86-261 (U.S. 1986).

The Writ should also be denied because the alleged lack of harmony with earlier decisions which the Petitioner professes to see is in fact illusory. In Petitioner's statement of "Reasons For Granting The Writ," Petitioner asserts that the decision of the Tennessee Supreme Court is in conflict with *First National Bank of Atlanta v. Bartow County Tax Assessors*, 470 U.S. 583 (1985). This assertion involves a drastic misreading of the *Bartow* case compared to the situation in the case at bar. In *Bartow*, Georgia law had included both state and federal obligations in the tax base, thereby eliminating any question of discrimination. In the case at bar, however, the necessary state of nondiscrimination has not been reached, because interest on the state and local obligations has never been made subject to the tax at all. Instead, the Tennessee Supreme Court, applying Tennessee principles of constitutional law, has consciously and deliberately rejected the Petitioner's invitation to preempt the legislature by extending the tax to state obligations. This case, therefore, involves no constraint on the power of the states to choose their method of compliance with the federal command

of nondiscrimination. Rather, it involves a situation where the Tennessee Courts have consciously chosen their own way of achieving the necessary nondiscrimination. The interplay of *Memphis*, *Bartow*, and the case at bar in no way imposes additional restrictions on a state's taxing power. Instead, each state is left free to accomplish the necessary nondiscrimination by the means of its own choosing. The real complaint of the Petitioner is that the Tennessee Supreme Court chose to defer to the Tennessee Legislature in the necessary redrafting of the taxing statute and did not accept the proposal urged on it by the State Commissioner of Revenue.

ARGUMENT

1. THE TENNESSEE SUPREME COURT'S DECISION BELOW WAS MANDATED BY *MEMPHIS BANK & TRUST CO. V. GARNER*, 459 U.S. 392 (1983).

The petition for certiorari should be denied because this Court's decision in *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), involving one of the same plaintiffs, the same defendant, and the same statutory provision as in the instant case, is controlling. This Court has already found, in *Memphis*, that Tenn. Code Ann. §67-2704 impermissibly discriminates against the Federal Government and those with whom it deals by including in the tax base interest earned on federal obligations while excluding interest from otherwise comparable Tennessee obligations. The tax at issue in this case is calculated in accordance with the definition of net earnings in Tenn. Code Ann. §67-2704, completely unchanged from the calculation condemned by this Court in *Memphis* as discriminatory. To resolve this discrimination, both the interest

from federal obligations and the interest from state obligations must be given equal treatment. In *Memphis*, this Court, citing *United States v. County of Fresno*, 429 U.S. 452 (1977), proclaimed:

> "a state tax imposed on those who deal with the Federal Government" is unconstitutional if the tax "is imposed [un]equally on . . . similarly situated constituents of the State." 459 U.S. at 397.

This equality of treatment is exactly the remedy granted by the Tennessee Supreme Court below. The Tennessee Supreme Court adhered to the ruling of this Court in *Memphis*. The Tennessee Supreme Court noted:

> The 1982 tax at issue in the case presently before the Court was calculated in accord with the definition of net earnings in T.C.A. §67-2704, unchanged from the definition condemned as discriminatory in *Garner*. Here, it was collected by the State as a general corporate excise tax, whereas in *Garner* the tax was payable to county and municipal governments, a difference of no significance.
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> . . . .
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> Having been adjudged discriminatory by the United States Supreme Court because of the total exclusion of Tennessee obligations, the federal obligations must be given identical treatment. . . . *Midland Bank & Trust Co. v. Olsen*, 717 S.W.2d 580, 582-583 (Tenn. 1986). (Appendix to Petition for Certiorari, A-1 through A-8).

2. THE TENNESSEE SUPREME COURT'S HOLDING BELOW CONFORMS WITH ALL PRIOR DECISIONS OF THIS COURT.

The decision of the Tennessee Supreme Court below was mandated by *Memphis* and does not conflict with or even involve the issue addressed in *First National Bank of Atlanta v. Bartow County Tax Assessors*, 470 U.S. 583 (1985). The *Bartow* case involved a nondiscriminatory property tax. As the Tennessee Supreme Court recognized, the tax involved in the instant case is not a property tax: "the tax in *Bartow* was a property tax whereas the tax in *Garner* and the present case is a 'franchise or other non-property tax' . . . ." 717 S.W.2d at 583. (Appendix to Petition for Certiorari, A-5.) In *Bartow*, Georgia state obligations and federal obligations were both included in the measure of the tax. Because both federal and state obligations were included in the tax base, the Court did not face an issue of unequal treatment between said obligations. *Memphis* was inapplicable to *Bartow* because no discrimination issue existed. Instead, *Bartow* addressed an unanswered issue raised in *American Bank & Trust Company v. Dallas County*, 463 U.S. 855 (1983). In the *American* case, this Court held that a nondiscriminatory state property tax computed on the basis of net assets without any deduction for obligations of the United States violates 31 U.S.C. §3124(a). In *Bartow*, this Court addressed a method by which federal obligations were excluded from a property tax which did not discriminate but included both federal and state obligations. This Court in *Bartow*, where no discrimination was involved, held that a proportionate deduction calculated to remove federal obligations to the same extent they were represented in the net asset base was permissible. This

Court expressly set forth that the *Bartow* proportionate deduction does not satisfy the Constitution when discrimination exists:

> This Court, in *Schuylkill Trust Company v. Pennsylvania*, 296 U.S. 113 (1935), struck down a state-trust-company share tax that provided a pro rata deduction for tax-exempt securities. That decision, however, rested on the fact that the tax discriminated against federal obligations by allowing a deduction for the value of shares the trust company held in corporations that already had been taxed or were exempt from taxes, without allowing a like deduction for federal obligations and shares the trust company held in national banks. The Court did not reach the issue whether, *absent* such discrimination, a pro rata deduction for federal obligations would have satisfied the Constitution or §3701. The decision, therefore, is of no controlling relevance here. 470 U.S. at 593 n. 6. [Emphasis in original.]

This statement by the Court was in conformity with its clarification in *Memphis* concerning the exemption of federal obligations where a state tax is discriminatory:

> Although the scope of the Federal Government's constitutional tax immunity has been interpreted more narrowly in recent years, there has been no departure from the principle that state taxes are constitutionally invalid if they discriminate against the Government. 459 U.S. at 397 n. 7.

After the proportionate deduction for federal obligations under the *Bartow* holding, Georgia state obligations remained in the tax base but federal obligations were excluded in a pro rata amount. This result actually gives preference to federal obligations, since they enjoy a proportionate deduction not extended to state obligations. The *Bartow* proportionate deduction approach does not resolve the discrimination in the Tennessee Corporate Excise Tax since the full amount of interest of Tennessee obligations would remain exempt from the tax base but a portion of interest of federal obligations would remain included in the tax base. This is the opposite result of *Bartow*. Thus the remedy in *Bartow* is not applicable to a factual situation that involves discrimination.

If the *Bartow* proportionate deduction is applied to the Tennessee Corporate Excise Tax, the total exemption given Tennessee obligations remains greater than the partial or proportionate exclusion given federal obligations. Thus the excise tax would still discriminate under the tests for discrimination established by this Court: 1) the tax would impose a greater burden on holders of federal property than on holders of similar state property; and 2) the tax would not remain the same regardless of whether United States or Tennessee obligations were held. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. at 397-98, *quoting Werner Machine Co. v. Director of Division of Taxation*, 350 U.S. 492, 493-494 (1956); see also, *Schuylkill Trust Co. v. Pennsylvania*, 296 U.S. 113 (1935); *United States v. New Mexico*, 455 U.S. 720 (1982).

Bartow, then, can have no applicability or relevance where the state tax is discriminatory because the pro-

portionate deduction cannot cure discrimination. For this reason the decision of the Tennessee Supreme Court below is not in conflict with *Bartow*. The only remedy for discrimination is a "like deduction," *see* 470 U.S. at 593 n. 6, for federal obligations and Tennessee obligations. This is exactly the remedy granted below consistent with *Memphis* and *Bartow*.[3]

Petitioner suggests that the decision below conflicts with *Bartow* because the exclusion of interest on federal obligations creates a tax shelter. What Petitioner overlooks in this argument is that Tenn. Code Ann. §67-2704 in its total exemption of interest on Tennessee obligations from the tax base provides for a tax shelter by virtue of ownership of Tennessee obligations. If a tax shelter results because of a like exclusion of interest of federal obligations from the tax base, that tax shelter is the product of affording equal treatment to federal obligations as granted by

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[3] Each state that has reviewed discriminatory net income or excise taxes has adopted the same reasoning of the Tennessee Supreme Court below in compliance with *Memphis* and *Bartow*. Each has rejected a proportionate deduction and has required identical treatment for federal and state obligations. *Forbes, Inc. v. Department of Finance, City of New York*, 66 N.Y.2d 243, 487 N.E.2d 251 (1985), *cert. denied*, No. 85-1371 (U.S. 1986); *Garfield Trust Company v. Director, Division of Taxation*, 102 N.J. 420, 508 A.2d 1104 (1986), *appeal dismissed*, No. 86-261 (U.S. 1986); *First of McAlester Corporation v. Oklahoma Tax Commission*, 709 P.2d 1026 (Okla. 1985); *State ex rel. Douglas v. Karnes*, 346 N.W.2d 231 (Neb. 1984); *Federal Products Corp. v. Norberg*, 429 A.2d 447 (R.I. 1981); *Commonwealth v. Curtis Publishing Co.*, 69 A.2d 410 (Pa. 1949), *cert. denied*, 339 U.S. 928 (1950). Defendant can cite no authority as to a discriminatory net income or excise tax where the courts permit continued discrimination by a mere pro rata deduction for federal obligations.

the statute to state obligations. If the legislature wishes to deal with the tax shelters thus created, it must do so in a manner that treats federal and Tennessee obligations equally. The legislature, in fact, has so dealt with the excise tax in its 1983 amendment of the Tennessee excise tax, as the Tennessee Supreme Court recognized:

> T.C.A. §67-2704, now codified as §67-4-805 has been amended so as to include in the calculation of taxable earnings, Tennessee obligations and federal obligations thus achieving the equality of treatment mandated in *Garner*. 717 S.W.2d at 582.

Petitioner claims the Tennessee legislature has the power to encourage investment in state bonds by creating a tax benefit for ownership of Tennessee bonds. The issue in this case is not the power of the state to create an equitable tax system, but the issue of this case is the supremacy of the federal government to preclude discrimination against federal obligations. *Memphis Bank & Trust Co. v. Garner* has answered Petitioner's claim on the state's treatment of Tennessee obligations and has told Petitioner that the state may create such a tax benefit for Tennessee bonds, but if it does so, it must also create an equal tax benefit for ownership of federal bonds. Any less equalization under the facts of this case fails to resolve the discrimination.

3. THE RESULT REACHED BY THE TENNESSEE SUPREME COURT IS FURTHER MANDATED BY THE TENNESSEE SUPREME COURT'S DECISION OF STATE LAW ISSUES.

A further reason for denying certiorari in this case lies in the fact that granting the Petitioner the relief

which it seeks would involve reversing the Tennessee Supreme Court on matters pertaining to that Court's authority and discretion under Tennessee law.

Specifically, the Petitioner seeks to require the Tennessee Supreme Court to achieve equality by imposing a judicially-created tax on Tennessee obligations to correspond to the legislatively enacted tax on federal obligations. This, the Tennessee Supreme Court has deliberately refused to do, both in the case at bar and in the unreported opinion on remand of *Memphis Bank & Trust Co. v. Garner.* (Appendix to Petition for Certiorari, A-17 through A-20). As the Tennessee Supreme Court pointed out, such an approach would amount to

> the imposition by statutory construction of a tax on earnings which the Legislature specifically exempted and which were not required at any time pertinent to this litigation to be included for taxation. It is our opinion that the doctrine of elision does not authorize this Court to remove the exemption of state securities contrary to express legislative direction and to subject them to taxation, even though the exemption itself has been held to be discriminatory. We continue to adhere to that ruling. (Appendix to Petition for Certiorari, A-6).

Given this insistence by the Tennessee Supreme Court, the Petitioner's reliance on the *Bartow* case becomes illusory. *Bartow* involved a tax which fell equally on the state and federal obligations, and this was a *sine qua non* of its result. By contrast, in the case at bar, the Tennessee Supreme Court has come

to the considered conclusion that it will not create a 1982 tax on state obligations by judicial fiat but will await the effect of remedial legislation. Under these circumstances, the necessary equalization can only be effected by removing the tax on the federal obligations as the courts below have done, and the Petitioner's reliance on the *Bartow* case creates a false issue.

CONCLUSION

For the foregoing reasons, Respondents respectfully request that Petitioner's Petition for Writ of Certiorari to this Honorable Court be denied.

Respectfully submitted,

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